No. 6459.

IN THE

United States Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

Commissioner of Internal Revenue,
Petitioner,

vs.

Murphy Oil Company, a corporation,
Respondent.

PETITION FOR REHEARING.

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No. 6459.

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vs.

Murphy Oil Company, a corporation,
Respondent.

PETITION FOR REHEARING.

To the Honorable Curtis D. Wilbur, William H. Sawtelle and William P. James, Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Comes now Murphy Oil Company and presents this its petition for a rehearing of the above entitled cause, and, in support thereof respectfully shows:

1. That this Honorable Court's opinion is in conflict with the basic theory of the Sixteenth Amendment to the Federal Constitution and the income tax laws in that the opinion fails to recognize the fundamental distinction between "capital" and "income" as outlined by the Supreme Court in the case of *Eisner v. Macomber,* 252 U. S. 189-206.

2. That this Honorable Court has misapplied the opinion of the Supreme Court rendered in the case of *Lynch v. Alworth-Stephens Company*, 267 U. S. 364 in that this Honorable Court has attempted to allocate between Murphy Oil Company and Standard Oil Company of California depletion allowances based upon the March 1, 1913 value; Standard Oil Company was not a lessee on March 1, 1913 and therefore under the income tax laws no allocation of depletion allowances is required or permitted; the opinion of the Supreme Court in the *Alworth-Stephens case, supra*, applies only where a lessor and a lessee have the same basic date for the determination of their depletion allowances, and does not apply to the Murphy Oil Company and the Standard Oil Company.

3. That this Honorable Court's opinion is in conflict with the basic conception of depletion in that:

(a) It fails to recognize the fundamental distinction between capital and income;

(b) It applies principles in the determination of depletion which are not applicable to the determination of depreciation and other similar charges, although the statutes specifically provide that the same basis shall be used.

(c) It forces the allowance of depletion deductions in years when there is no production or exhaustion of the mineral products.

(d) It treats the bonus payments as part payment for the sale of oil in place contrary to the decisions of the Supreme Court of the State of California and the Supreme Court of the United States.

4. Article 215, as amended of Regulations 45 (Article 216 Regulations 69) is void as it is arbitrary and capricious and does not constitute a reasonable exercise of the Commissioner's authority to make regulations.

5. If Article 215, as amended of Regulations 45 is valid, then the burden of pleading and proving the allocation contended for by the Commissioner in this case was not upon the taxpayer but was upon the Commissioner. Hence the decision of the Board should be sustained.

POINT I.

This Honorable Court's Opinion Is in Conflict With the Basic Theory of the Sixteenth Amendment to the Federal Constitution and the Income Tax Laws.

The decision of this Honorable Court is contrary to the basic theory of the income tax laws and the Sixteenth Amendment to the Constitution. The constitutional amendment and income tax laws were founded upon the theory that all gains including gains derived from capital are taxable and that the conversion of capital into money is not a gain unless the amount received exceeds the basic cost of the capital.

In order to avoid taxing gains realized prior to the effective date of the constitutional amendment Congress provided that the value of the capital on March 1, 1913 should be its cost, and the gain would be the difference between this statutory cost and the amount received on conversion. In the case of property acquired since March 1, 1913, the actual cost is the starting point for determining gain. The cost or March 1, 1913 value, in case of

property acquired prior thereto is also the statutory basis for the determination of the deductions allowable in respect to depreciation, depletion, obsolescence, etc. When there is a *sale* of property and the amount of money received is equal to the March 1, 1913 value, it is regarded as "a return of the taxpayer's basic cost" and is not taxable. The constitutional amendment and the income tax laws are founded upon the theory that moneys derived from the use of property constitute taxable income for the year in which received.

Section 213 (a) of the Revenue Act of 1918, which is practically identical with similar provisions in all other acts, specifically provides that gross income shall include gains, profits and rents "growing out of the ownership or use of" property. It is therefore clearly seen that no part of the moneys derived from the "use of property" constitute a return of capital. The whole amount is taxable income. It is true that in the determination of the *net taxable income* the statutory allowances for depreciation and depletion are to be deducted. Depreciation and depletion, occur irrespective of whether or not taxable income is derived and the deductions for these allowances can be taken only during the year when they are actually sustained.

The foregoing dissertation is supported by the decision of the Supreme Court in the case of *Eisner v. Macomber*, 252 U. S. 189, 206, wherein the Supreme Court said:

> "The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir

supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time.

* * * * * * * * * *

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. 'Derived-from-capital,' 'the gain-derived-from-capital,' etc. Here we have the essential matter; not a gain accruing to capital; not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being 'derived'—that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal—that is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment—'incomes, from whatever source derived'—."

Moneys derived from the use of property such as rents may be likened, as the Supreme Court stated in the last cited case, to the "fruit of the tree or the crop." It often happens that lease rentals equal or even exceed the basic cost of property. Whether such rentals do exceed the basic cost of the property is immaterial in determining annual net income. If taxpayers were able to deduct from such rentals the basic cost of the property no tax would be due until an amount equivalent to the full basic cost was returned.

The opinion of this Honorable Court, it is most respectfully submitted, is based upon an erroneous conception of the constitutional amendment and the income tax laws; under the opinion the taxpayer, Murphy Oil Company, is required to charge against lease rentals received the statutory basic cost of its property although no portion of its property had been "sold or exchanged." The "bonus" represented nothing but the "fruit of the tree or the crop." By the execution of the lease and the receipt of the bonus the Murphy Oil Co. did not part with title to any portion of its property; it still retained the property it had. It is true it received a very large sum of money, but that sum of money was not derived from a "sale" of property. Both the petitioner and respondent agree that there was no sale of any property. Indeed under the established law no sale could have been made. Therefore, since there was no sale there was no conversion of property and consequently there was no *"return of capital."* Before there could be a *"return"* of capital there necessarily would have to be a sale of or parting with capital. Does an owner of a city office building have a return of his capital merely because he receives a large sum as advance rentals? Suppose such an owner made a long-term lease and received one million dollars as advance rentals or bonus, and suppose the statutory basic cost of his property was one million dollars, would such an owner be permitted to charge his statutory basic cost against the amount received and thereby escape paying any tax whatsoever on the advance rentals? The principle enunciated by the Supreme Court in the case of *Eisner v. Macomber supra,* would forbid the taxpayer to reduce his rentals by the statutory basic

cost of his property. However, under the opinion of this Honorable Court such a taxpayer would be entitled to reduce his rentals by his statutory basic cost. A bonus does in fact constitute the "fruit of the tree, or the crop" and even though a bonus does exceed the basic statutory cost still it, under the constitutional amendment and the Revenue Acts would constitute income in its entirety. (Taxable income is a statutory concept, of course based upon reality.) And it would make no difference if the *value* of the property should thereafter decrease even below the basic statutory cost. A decrease in value of property does not establish an income tax loss. Stocks may depreciate to almost nothing and still a taxpayer will not sustain an income tax loss until the stocks are actually sold.

Suppose a person should purchase just before the declaration of a dividend 10 shares of stock of the United States Steel Company for a total consideration of $1000.00 and suppose such a person should shortly after the purchase receive a total dividend on these stocks of $1000.00. Is he permitted to charge against the dividend his basic statutory cost? Under the Honorable Court's opinion as we interpret it such a taxpayer would be entitled to do so; under the Supreme Court's opinion in the *Eisner v. Macomber case supra*, the dividend would represent the "fruit of the tree or the crop." Of course, the ten shares of steel stock would be worth less after the dividend than before for the very obvious reason that the surplus of the steel company would have been depleted by the total dividend paid. It is obvious therefore that in the determination of annual net taxable income the values of unsold

properties are not taken into consideration; furthermore. there is no reason for making an allowance for the reduction if any of the basic statutory cost of property. The basic statutory cost of unsold property is never taken into consideration in the determination of net taxable income except for the purposes of determining the *annual* deduction for depreciation and/or depletion; and in the determination of these *annual* deductions the statutory basic cost is stationary; it is not variable—once determined it never changes. In other words, in the determination of the annual deductions for depreciation and/or depletion no consideration is given to changes in the statutory basic cost due to lessening or increasing values of the properties. Suppose an office building having a value on March 1, 1913 of $100,000.00 should in 1918, due to increased population, become worth $1,000,000.00. From an accounting and financial standpoint it might be highly desirable to compute depreciation on the basis of the increased value, but insofar as federal taxes are concerned the owner of such a building would be restricted to the statutory basic cost. Again, suppose a building having a value on March 1, 1913 of $1,000,000.00 should in 1918 become worth only $100,000.00; depreciation would, of course, be computed on the statutory basic cost of $1,000,000.00. Substantially, there is no difference in the allowance for depreciation and depletion. The statutes treat them the same and specifically provide that the basis for determining these allowances is the same. The Supreme Court in the case of *U. S. v. Ludey*, 274 U. S. 295, 304, stated:

> "In essence, the deduction for depletion does not differ from the deduction for depreciation."

These allowances are made to be taken advantage of only when depreciation and/or depletion is actually sustained, for it is well settled that these allowances may not be accumulated; that is an amount representing several years depreciation may not be taken in a year when income is large. In other words, depreciation and depletion do not depend upon income; even though there may be a loss from operations, still depreciation and depletion must be deducted. (*Burnet v. Thompson Oil & Gas Co.*, 283 U. S. 301.)

As heretofore shown a taxpayer under the theory and provisions of the constitutional amendment and the income tax laws does not have a *return of his statutory basic cost* until he sells or exchanges his property; quite naturally he cannot have a *return* until he has *parted* with his property. Therefore, it is absolutely essential in determining what moneys received by a taxpayer constitute taxable income, to keep in mind the *fundamental* principle laid down by the Supreme Court in the *Eisner v. Macomber* case, *supra.* Keeping in mind these fundamental principles let us analyze the bonus payments received by the Murphy Oil Co. The regulations adopted by the Commissioner to be valid cannot apply to a bonus which does not by the contract of lessor and lessee involve a consumption and reduction of the oil in the land leased.

What a bonus was paid for depends on, and must be determined by, the contract of the lessor and lessee in each case.

If, by the payment of a bonus, the lessee does not under the terms of his lease acquire an interest in the oil in the

ground, then no part of the bonus can be said to be a recovery of capital and the bonus is not properly considered as a part of the royalties and hence no depletion deduction should be allowed in respect thereto.

What is or was this $5,500,000 to be paid for?

What the $5,500,000 was to buy and was paid for is determined by the lease:

> "The second party, *in consideration* of the *conveyance* and *sale* and *of the lease* all as hereinafter set forth *and independently of and in addition* to the royalties and other considerations in this instrument herein and hereinafter provided has paid to the first party the sum of Ten Dollars ($10.00) and other sums and other considerations, the receipt of which by the first party is hereby acknowledged, and agrees to further pay *independently* of the said royalties and said other considerations to the first party the sum of One Million Dollars ($1,000,000) on or before four (4) months from the date hereof with interest at the rate of five per cent per annum from date until paid;" etc. (Italics ours), [R. 181];

and then follow the provisions for the remaining installment payments.

The conveyance and sale above referred to is:

> "The first party, for and in consideration of the payments *made* and by the second party *to be made as hereinbefore set forth*, and of the other considerations *paid and delivered* by the second party hereinbefore referred to, has * * * sold, conveyed, * * * and * * set over unto the second party absolutely, and for and as the sole property of the second party * *," etc. [R. 183] (Italics ours),

the personal property mentioned in the lease.

To what do the "payments made" and "to be made as hereinbefore set forth" refer? They refer to the payment

of $1,500,000 made at the time the lease was signed [R. 238] and the payments to be made in cash installments, as a reading of the prior provisions of the lease above quoted and referred to clearly show.

The $5,500,000 was not under the terms of the lease a price for the oil or else the lease would have required the royalty payments of one-fourth part of all the petroleum oil produced and saved, when produced and saved and payable, to be credited upon it. On the contrary [R. 44], $326,404.82 of the price paid by the lessee was in payment for the personal property of the lessor described in the lease [R. 183] and sold outright and delivered and transferred to the lessee by bill of sale [R. 184] therein mentioned.

The remaining $5,173,595.18 was a bonus agreed to be paid

> "in consideration * * of the lease" [R. 181];

that is, *for the execution of the lease* and was payable whether or not the lessee ever entered upon and drilled the property. The bonus so received by the Murphy Oil Company was, in the language of the Supreme Court, the "fruit of the tree or the crop." The bonus had absolutely nothing to do with the production of petroleum products; the payment of the bonus was not dependent upon the discovery and/or production of oil.

The bonus, by the very terms of the lease is separated and segregated and classified as a thing apart from the royalties therein provided for in that the lease provides that the cash consideration is

> "independently of and in addition to the royalties."

In order to sustain the view of this court that the lessee had an interest in each of the 40,763,254 barrels of oil in the ground by virtue of the payment of the bonus, the court must hold, contrary to the contract of the lessor and lessee, that the bonus was not paid

"in consideration of the lease"

nor

"independently of and in addition to the royalties."

By the very terms of the lease itself it appears that the bonus was paid for the execution of the lease and the royalty was paid for the oil.

Under the terms of the lease, no part of the one-fourth royalty was to be credited upon the bonus and the bonus was paid

"independently of and in addition to the royalties,"

hence it necessarily follows that the bonus was not paid for an interest in the oil in the ground.

The Circuit Court of Appeals for the Fourth Circuit considered somewhat similar terms in a lease in *Browning v. Boswell,* 215 Fed. 826, and held at page 834:

> "(1) What is this contract? It is one conferring on Boswell the right to enter upon the Browning's land and remove all the coal underlying it of this particular seam upon certain conditions and for a fixed price to be paid for each ton to be removed. What is or was this $200,000.00 to be paid for? Certainly not as a price for the coal or else the contract would have required the royalty payments of 15¢ per ton when removed and payable to be credited upon it. On the contrary, $25,000.00 of it was for plant and personal property sold outright at value and delivered and the remaining $175,000.00 was a bonus agreed to be paid for the right to mine and remove whatever coal might underlie the land at a cost of 15¢ per ton

> upon the conditions and terms of payment set forth in the lease contract. In other words this was a mining lease and not a sale of either land or coal by the acre nor of a fixed quantity or number of tons, but, on the contrary, a right in gross, as specifically set forth in the contract to remove all the No. 3 seam of coal, much or little, underlying the land."

The United States Circuit Court, E. D. (Okla.) in *Moore v. Sawyer,* 167 Fed. 826, considered the payment of a bonus and the effect thereof. Said the court, at page 835:

> "Applying to this instrument the ordinary rules of construction, and considering all its parts with a view of harmonizing them and arriving at the real intention of the parties, it is in my opinion, simply a lease, the $50.00 mentioned being merely a bonus paid or agreed to be paid to induce its execution."

This Honorable Court held:

> "By the payment of the bonus of $4,517,402.70 (the lessee) had an interest in each of the 40,763,254 barrels of oil in the ground,".

From the points and authorities above mentioned, it clearly appears that such is not the rule applicable to the language employed in the lease here involved.

The Supreme Court of California in considering the effect of an oil lease held:

> "It grants only the right to do certain things thereon and to take certain mineral substances therefrom, and no title to such substances passes from the original owner until the same is severed from the realty."
>
> *Brookshire Oil Company v. Casmalia Etc. Co.,* 156 Cal. 211, 215.

We respectfully submit that this Honorable Court has departed entirely from the contract between the lessor

and lessee in reaching its decision in this case on the bonus question.

The bonus and its payment by the contract of the lessor and lessee was not in any way dependent upon oil production nor related to oil production, and was paid

"independently of and in addition to the royalties"

and cannot, therefore, for income tax purposes be termed a "return of capital."

The Board of Tax Appeals [R. 245] and this Honorable Court (Opn. pp. 5, 6) both held that the payment of the bonus from lessee to lessor was not dependent upon oil production. In that regard this Honorable Court held:

> "The lessee agreed to pay this money in installments extending over a period of five years, aggregating $4,517,402.70, regardless of whether or not any oil was produced from the property during that period."

The distinction between the bonus and the royalty provided in the lease at bar is shown in the lease, itself, as aforesaid, and, with respect to the royalty, a one-fourth royalty was only due and payable if, as and when production was obtained. If production was obtained, then the royalties were earned and became due and payable and as exhaustion of mineral resources resulted a depletion deduction or allowance would apply thereto. If no production was obtained, then no royalty was earned or due or payable and as no exhaustion of mineral resources resulted a depletion deduction or allowance could not, of course, apply.

The bonus is not subject to a depletion deduction or allowance as its payment was made

"independently of and in addition to the royalties," and was not based upon production nor paid for an interest in the oil in the ground, and therefore is not a return of capital.

Depletion is dependent upon the exhaustion of mineral resources. Exhaustion of mineral resources is the depletion of those resources. Without the exhaustion of mineral resources there can be no depletion. The bonus in this case and the payment thereof was not dependent upon, nor did it relate to, the exhaustion of mineral resources.

On December 1, 1913, the date the lease was entered into, Murphy Oil Company received $1,500,000, and the Subsequent installment payments at the times stated in the record [R. 238]. The total cash payment was $5,500,000. It having been held as aforesaid that the bonus payments were not dependent upon oil production, the depletion concept cannot be applied thereto as the bonus payments did not reduce, nor result in a reduction of, the mineral contents of the reserves.

> *United States v. Ludey*, 274 U. S. 295, 71 L. Ed. 1054;
>
> *Lynch v. Alworth-Stephens Co.*, 267 U. S. 264, 69 L. Ed. 660;
>
> *Von Baumbach v. Sargent Land Company*, 242 U. S. 503, 61 L. Ed. 460.

The bonus was income and taxable as such.

This Honorable Court has held (Opn. p. 15):

> "* * * The whole theory of the depletion allowance is that the proceeds derived from the sale of royalty oil is of necessity in part a return of capital."

What oil or royalty oil was sold to pay the bonus? None. *And, there being none, wherein is the payment and receipt of the bonus in whole or in part a return of capital?*

It follows that the payment of the bonus, not depending upon nor relating to oil production and not being proceeds derived from oil or the sale of oil, is not subject to the theory of the depletion allowance for the reason that the bonus payments were not proceeds derived from the sale of oil or of royalty oil—there was no exhaustion of resources through production or otherwise upon which the bonus payments depended, nor were made. The payment of the bonus was not dependent upon a recovery or return of capital through conversion from the form of oil resources into marketable products or otherwise. The theory of the depletion allowance can only be measured by reference to oil produced, and for oil produced in the years of the bonus payments, in the event such payments were dependent upon oil production. It follows that the bonus was not a return of capital in whole or in part but was wholly income and taxable as such.

The government and the taxpayer both agree that, under the terms of the lease, there was and could have been no sale of oil. There having been no sale, of course there could have been no *parting* with or conversion of capital. Hence, there was no return of capital. The bonus payments were the "fruit of the tree, or crop." Therefore, the whole amount thereof was taxable income. The production of oil and the receipt by the Murphy Oil Company of its royalty because of such production constituted a sale or exchange, a conversion of or parting

with capital and quite naturally the royalty so received by the Murphy Oil Company represented in part a "return of its capital"—statutory basic cost. To hold, as this Honorable Court did, that the bonus payments, which were made and required to be made "independently" of royalties, constituted a return of capital—statutory basic cost—is to ignore the basic concept of the constitutional amendment and the income tax laws, and the lease.

As we interpret the court's opinion, it is predicated upon the conclusion that a portion of the bonus represented a "return of capital," because after the execution of the lease Murphy Oil Company "could not hope to get more for the land subject to the lease than the $11,030,119.47." The same would be true of a fee owner of city property who had leased his property for an amount greater than the basic cost. From an income tax viewpoint it does not make any difference how much is received as rent or "fruit of the tree or the crop." The base for depletion and depreciation remain constant and is not altered by subsequent changes in value. The court understood that the Commissioner fixed the value of the land at the time of the execution of the lease. Indeed, there was no occasion therefor and had the Commissioner so fixed the value his action would have been illegal. The depletion schedule from which the court acquired this misunderstanding merely attempts to show the residual value—March 1, 1913, value less actual exhaustion to December 1, 1913—of the depletable base and not the "value" of the property at the later date.

Either the whole bonus constituted a return of capital, or the whole bonus constituted income. Either the lease

contract constituted a sale of the oil or it did not constitute a sale of the oil. Both parties litigant agreed that there could not have been a sale of the oil. Since there was no sale, how could any part of the bonus be considered a "return of capital." In determining whether the bonus represented a return of capital or income, we must necessarily be governed by the terms of the lease and the conditions under which it was executed. A formula cannot be substituted for the lease and the character of the bonus thereby changed from income to capital. The present income tax laws treat capital gains differently from ordinary income. Naturally capital gains arise only when there is a sale of property and the amount received is in excess of the basic cost. Under the court's opinion, how would it be possible to determine what portion of the bonus would be subject to the capital gain tax and what would be subject to ordinary tax. Certainly a formula cannot determine that when the act specifically states that gains from capital shall be taxed at a certain rate and income at another rate. A gain arises either from the use or sale of property. If it arises from the use of property, then it is ordinary income; if it arises because of a sale, then it is a capital gain and the amount received represents a return of capital to the extent of the basic cost. Since both the litigants in the instant appeal agree that there was no sale, how can this court hold in effect that there was a sale? To hold that the lease was a sale is to disregard the very terms of the lease and to run counter to

the fundamental concept of the constitutional amendment and the income tax laws. The bonus in this case cannot be treated as a return of capital, as expressed in the formula on page 13 of the court's opinion for the reason that the bonus in the formula is placed upon a par with the actual receipts from the sale of oil by assuming that the bonus represents a gain from the sale of property. The character of the bonus in the case at bar must be determined by the lease contract,—the contract between the lessor and the lessee—and not a formula. The moneys received under the terms of the lease and referred to as the bonus payments represented, in their entirety, income within the meaning of the Sixteenth Amendment and the income tax laws as interpreted by the Supreme Court in the *Eisner v. Macomber* case, *supra*. If moneys received constitute income for the use of property, then they are taxable as such and if moneys received constitute a gain resulting from the sale of property, then they are designated by the Revenue Act as a capital gain. Certainly a formula cannot change the concept of the statute. It would be absolutely impossible for anyone if they are confined to the terms of the lease and the conditions existing at the time of its execution to determine under the Commissioner's theory what part represented a gain from capital and what part represented a gain from the use of property. There are too many uncertain elements or factors in the Commissioner's formula. The most uncertain fact is the price of oil at future dates.

The very nature of the bonus payments are disturbed by the application of the formula. This formula is absolutely in conflict with the law since by its operation it converts taxable income derived from the use of property into a partial gain derived from the conversion of property. By the use of this formula it would have been impossible to determine on March 1, 1913, or December 1, 1913 what portion of the bonus payments represented a gain from the use of property and what part constituted a gain derived from the sale of property. Even now because of the uncertainty of the most important factor, namely the future market price of oil it is impossible to determine this question.

The statute does not permit the Commissioner to shift a gain from capital to ordinary income and likewise does not permit the Commissioner to shift ordinary income to capital.

In view of the foregoing it is respectfully submitted that the opinion of this Honorable Court is in conflict with the basic concept of the constitutional amendment and income tax laws and particularly as expressed by the Supreme Court in the *Eisner v. Macomber* case, *supra;* it is further respectfully submitted that the bonus payments represent as stated by the Supreme Court in that case the "fruit of the tree or the crop" and that therefore the entire bonus payments represented taxable income and consequently no part represented a return of capital through depletion or otherwise, therefore it is respectfully submitted that the court's opinion is based upon erroneous premises.

POINT II.

This Honorable Court Has Misapplied the Opinion of the Supreme Court Rendered in the Case of Lynch v. Alworth-Stephens Company, 267 U. S. 364.

Up to page 7 of this court's opinion the bonus question is discussed "on *principle* rather than on authority." The conclusion so reached "on principle" is to the effect that the fee valuation of $15,710,899.52 represented the total combined interest of the taxpayer as lessor, and the Standard Oil Company as lessee, and that no greater sum should be depleted. In support of this conclusion Section 234(a) (9) of the 1918 Act and also Section 214(a) (10) are referred to, particularly the last sentence, to the effect that the depletion deduction "shall be equitably apportioned between the lessor and lessee." The decision that not more than $15,547,522.17 should be depleted after November 30, 1913, by lessor and lessee cannot be reconciled with the later conclusion of the opinion that article 215 of Regulations 45, as amended, is valid. (See page 16 of opinion.) That regulation, to put it simply, permits depletion *to the lessor* with respect to the *entire* March 1, 1913 value. It simply rules that part of that value should be applied against the bonus by providing that the taxpayer lessor shall be entitled to deduct "that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and royalties to be received."

Since the lessee is by the statute and the Regulations permitted depletion of the cost where the lease is entered into subsequent to February 28, 1913, the gross depletion

in this case under the regulations must equal $15,710,-899.52 allowed to the taxpayer lessor and $4,517,402.70 allowed the Standard Oil Company, lessee, or a total of $20,228,302.22.

Thus, the court's conclusion that article 215, as amended, is valid is wholly inconsistent with the reasoning that not more than the total basic value at March 1, 1913, should be deducted by lessor and lessee.

With the court's indulgence it is suggested that an apparent explanation of its conclusion is furnished by the court's reference to the last sentence in Section 214 (a) (10) of the 1918 Act also Section 234 (a) (9) as requiring the approval of the Commissioner's regulation. That section provides that "in the cases of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *." To interpret this provision this court refers to the case of *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364 (page 8 of the opinion), placing particular emphasis on that part of the opinion of the United States Supreme Court, wherein it was stated that:

> " * * * There is an exhaustion of property in the one case as in the other; and the extent of it, with the *consequent deduction to be made, in each case is to be arrived at in the same way, namely, by determining the aggregate amount of the depletion of the mines in which the several interests inhere, based upon the market value of the product, and allocating that amount in proportion to the interest of each severally considered.*" (Pp. 370, 371.) (Italics ours.)

Upon the basis of the above quoted statement this court says (page 10) that "the allowance of the total depletion

to the lessor, as was required by the decision of the Board of Tax Appeals (in this case), left nothing to be apportioned to the interest of the lessee in the property." It is respectfully urged that the conclusion reached in this sentence reflects an incorrect application of the true meaning of the *Alworth-Stephens case.*

The situation with respect to the allowance of depletion to *lessees* at the time of the enactment of the 1918 Act must be kept in mind if the significance of the quoted apportionment provision as between lessor and lessee, inserted in the 1918 Act for the first time, is to be fully realized. In Regulations 33, revised, interpreting the 1916 Act, it was ruled that in the case of an *operating fee owner* the amount returnable through depletion deductions was the fair market value of the property as of March 1, 1913, and that in the case of a *lessee*, the capital to be returned was the amount paid in cash or its equivalent as a bonus or otherwise by the lessee for the lease, plus certain additional expenses.* The *operating owner* was permitted to take depletion on the basis of the cost or *March 1, 1913 value*, if greater than cost; the *lessee* was limited to depletion based on *cost* even though the lease was entered into or acquired prior to March 1st, 1913, and had a value at that date greater than cost.

Sections 214 (a) (10) and 234 (a) (9) were intended to correct this irregularity. That this was the purpose

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*See also T. D. 2447 (unpublished; see reference thereto in Part I, p. 524, of Hearings before Committee on Ways and Means on Revenue Act of 1918) in which it was ruled:

"That lessees have no capital invested in such properties and are, therefore, not entitled to the deduction, this deduction being allowed only to the owner in fee."

sought to be secured by the provision in the 1918 Act apportioning depletion between lessor and lessee is apparent from the hearings held before the Ways and Means Committee and the Finance Committee in connection with the 1918 Act. (See Hearings before the Committee on Ways and Means, House of Representatives, on the proposed Revenue Act of 1918, Part One, particularly pages 515, 572; Hearings before Finance Committee, 65th Congress, second session on HR 12863.

A very material and substantial part of the discussion of these hearings related to the refusal of the Commissioner of Internal Revenue to construe the 1916 Act, as amended, so as to permit *lessees* to take depletion based *on the March 1, 1913 value.* To remedy this inequality many interested persons testifying before the Committees proposed a number of amendments. (See Hearings before Committee on Ways and Means, *supra*, particularly pages 528, 545.)

The language of the proposed amendments is substantially the same as the language incorporated in Sections 214 (a) (10) and 234 (a) (9) of the 1918 Act. It was recommended (page 545) that the Act should include a provision to the effect that

> "The allowance for exhaustion and depletion herein provided for under (a) and (b) shall be made to all parties interested therein, including owners, lessors and lessees, to the extent of the value of their respective rights or interests therein."

In connection with this suggested amendment it was pointed out to the Congressional Committees that the then recent decision of the United States Supreme Court in the

case of *United States v. Biwabik Mining Co.,* decided on May 20, 1918 (247 U. S. 116) reaffirmed the proposition that leases of the kind ordinarily in effect in connection with depletable properties were merely grants of the privilege of entering upon, discovering, developing and removing the minerals from the land; and that since the lessee was in no legal sense a purchaser of the ore in place, it was practically impossible to classify lessees as purchasers so as to bring them within the provisions of the 1916 Act, limiting depletion on March 1, 1913 value to *owners or purchasers* of the property.

The 1918 Act was not retroactive beyond January 1, 1918, and did not help lessees as to years prior to 1918. Whether *lessees* were entitled *under the 1916 Act* to depletion based on March 1, 1913 value was the question later decided in the *Alworth-Stephens* case. It was held in that case that where the lease was entered into *prior* to March 1, 1913, and was in effect on that date the total interest therein was to be divided between the lessor and lessee and that the value at March 1, 1913 of the lessee's interest therein was depletable. The theory of the court was that although the lessee might not have acquired the minerals in place, his privilege was a property right at March 1, 1913, the value of which should be returned to the lessee by the depletion allowance or otherwise.

There was no necessity of providing in the 1918 statute for the allowance of depletion to the lessee. That was already permitted. The necessity was to make it clear that he should have a revaluation of his interest if the lease antedated March 1, 1913, as was allowed to the lessor. The inequality sought to be cured by the lessor-lessee ap-

portionment provision was the refusal of the Commssioner to permit the lessee to take depletion *on the basis of March 1, 1913 value of its interest*, as distinguished from cost, although permitting depletion to the lessor on the basis of the value as at March 1, 1913. The Supreme Court in the *Alworth-Stephens* case said that the interests of the lessor and the lessee in the property on March 1, 1913, were in both instances subject to depletion and that the total depletion of the property should be apportioned between the lessee and the lessor based on their respective interests in the property on March 1, 1913.

The language of the Supreme Court in the *Alworth-Stephens* case, italicized in this court's opinion, should be interpreted in the light of the problem before the Supreme Court and the decision and the significance of the italicized words should be limited to cases dealing with *the apportionment of March 1, 1913 value* between a lessor and a lessee when the lease was entered into *prior to that date.* There is no question in this case as to apportionment of value at March 1, 1913, between lessor and lessee because there was not at that date a lessor and lessee. There was simply a fee owner, the taxpayer. The lease involved in the *Alworth-Stephens* case was dated long before March 1, 1913. The facts of the *Alworth-Stephens* case do not support any conclusion that the capital sum of a fee owner returnable through depletion should be reduced in cases in which a fee owner leased property subsequently to February 28, 1913. The statute prescribes "cost" as a general basis for depletion in the first part of subdivision 10 of Section 214 (a). This provision gives the basis for the Standard Oil Company's depletion. The first proviso has nothing to do with the Standard

Oil Company because its property was not "acquired prior to March 1, 1913." This proviso does, however, apply to the taxpayer because it had acquired its properties in 1904. The proviso plainly establishes as the basis of the taxpayer's depletion *in lieu of the cost* in 1904, or up to March 1, 1913, "the fair market value of the property (the taxpayer's interest therein)" on March 1, 1913, which is conceded to be $15,710,899.52. "The taxpayer's interest therein" was the *entire* interest in the property at that date. There was no interest in any other person. The Standard Oil Company did not acquire its interest until several months later. There were not, therefore, two or more interests at March 1, 1913, among which the value at that date could be apportioned. There is nothing in the statute from which it can even be implied that the value of a taxpayer's interest at March 1, 1913, should be reduced because the taxpayer *subsequently* leases property and the lessee acquires a basis by reason of his payment. The *Alworth-Stephens* case holds that the value at March 1, 1913, should be apportioned between the interests in the property existing on that date, even though the lessee of an oil and gas lease may have nothing more than a privilege of extraction. The so-called apportionment clause at the end of subdivision (10) merely apportions "deductions allowed by this paragraph," which means likewise that the deduction of value at March 1, 1913, should be apportioned between the interests existing on that date and not that the value of the taxpayer's interest on that date, which affords the basis for his depletion deduction, should be reduced or modified on account of all subsequent transactions affecting the interest so that all persons concerned do not re-

ceive the benefit of a deduction over the life of the property of more than the value on that date. The only basis for any reduction would be a sale of part of the property interest existing on March 1, 1913, with the result that from the date of sale taxpayer should be restricted in his deduction to the net property retained. All the authorities, however, to the effect that the bonus is income, as distinguished from return of capital, negative completely the idea of any subsequent sale.

POINT III.

This Honorable Court's Opinion Is in Conflict With the Basic Conception of Depletion.

When the Board said that Article 215 of Regulations 45 was a departure from the depletion concept, it spoke on the basis of an extended experience with depletion problems. It is believed that this court would not have reversed the Board but for the inconsistency of premises above discussed. The inconsistencies are sufficiently basic and vital to this court's decision to justify further study of the Board's opinion on the bonus point and the reasons which must have impelled it to reach those conclusions. The Board's opinion is summed up in the statement that it considered Article 215 of Regulations 45, as amended, to be *"a departure from the depletion concept."* (Page 13 of the opinion of this court.)

In making this statement the Board undoubtedly had distinctly in mind one basic premise—that depletion is a *statutory* concept.

Section 232 of the Act provides for the computation of *net income* as follows:

"Sec. 232. That in the case of a corporation subject to the tax imposed by section 230 the term 'net income' means the gross income as defined in section 233 less the deductions allowed by section 234, * * * ."

Sections 213 and 233, defining *gross income*, required the inclusion of "gains, profits, and income derived from * * * sales, or dealings in property, * * * growing out of the ownership, or use of, or interest in such property * * * rents * * * or gains or profits and income derived from any source whatever."

In the absence of any statutory deduction provision all royalties would have bee ntaxable as income. (*Stanton v. Baltic Mining Co.*, 240 U. S. 103; *Stratton's Independence Ltd. v. Howbert*, 231 U. S. 399; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503.) There is no inherent right to depletion; the allowance is a matter of legislative grace. (See *Burnet v. Thompson Oil & Gas Company*, 283 U. S. 301, and also cases cited on page 12 of Government brief.)

Section 234 (and section 214) lists the *deductions* to be made from gross income. The section permits several deductions, *not one of which is dependent upon or directly related to any item of gross income.*

It is inherent in this statutory structure that all items of gross income are taxable when received or accrued and that all deductions are applied against income when paid or incurred without regard to particular items. Particular items of gross income are not to be subdivided into income and deduction as a molecule may be subdivided into atoms. Net income in the sense of the statute is a statu-

tory creation not synonymous with net profit, net gain, net revenue or any other such term. (*Weiss v. Wiener*, 279 U. S. 333.) It is the total of the items to be included in gross income of the particular year pursuant to sections 213 and 233, less the total of the deduction items allowed in sections 214 and 234 which allowances are determined irrespective of income.

The Board in its decision undoubtedly had in mind this statutory structure when it declared article 215, as amended, to be "void because in conflict with the statute." (Page 13 of opinion.) Moreover, it had in mind the basic intention of Congress in making a statutory reservation from income of an allowance for depreciation, amortization and depletion.

That concept is not that each dollar of royalty should be analyzed to determine a proportion of capital and a proportion of income. It is simply that *over the life of property* subject to depletion, the taxpayer should be permitted to have returned free from tax a part of his income as a deduction for depletion of the property giving rise to the income. There is no return of capital unless the property itself is actually used up, exhausted, or depleted.

The tax is, as a matter of necessary convenience, based on annual periods. (*Burnet v. Thompson Oil & Gas Company*, 283 U. S. 301, 307; *United States v. Ludey*, 274 U. S. 295.) The taxpayer may, or he may not, in any annual period have income. Whether he has income has nothing to do with what he deducts. He must in each year take in his income as it is received or accrued and he must in each year take the deductions appertaining

to that year. He cannot relate the deductions to particular items of income or subdivide dollars of receipts into gross income and deductions, or income and capital. He cannot deduct depletion according to the fluctuations of his income; if he has not sufficient income the benefit of the deduction is forever lost.

The depletion provision, like the depreciation provision, deals with a question of fact. (*The Hotel de France Co.*, 1 B. T. A. 28; *Cleveland Home Brewing Co.*, 1 B. T. A. 87; *Walnut Creek Milling Co.*, 3 B. T. A. 558; *Richardson*, 9 B. T. A. 875; *Brampton Woolen Co.*, 18 B. T. A. 1075, reversed on other grounds, 45 Fed. (2d) 327.) The allowance is dependent not on the amount or existence of income received but on quite a different fact, viz., *whether there has been exhaustion of the property.* Congress had in mind the idea that *over the life of properties* the taxpayer's "invested capital" (which in the case of property acquired prior to 1913 should be the value on that date) should be returned free from tax. It did not have in mind any such idealistic scheme as segregation of the income from oil properties and the allocation of the depletion allowance over the years *in accordance with the income* derived from such properties.

The Bureau of Internal Revenue appreciated this statutory concept of depletion and depreciation and has uniformly so applied the provision. The one and only deviation was the one which was disapproved by the Board in this case.

From every point of view the authorities are unanimous in adhering strictly to this basic concept of depletion. Consistent adherence to the concept can be observed

running through the many authorities dealing with the treatment of bonuses as income. See *Berg v. Commissioner*, 33 Fed. (2d) 641, (C. A., D. C. 1929) *certiorari* denied 280 U. S. 598, affirming 6 B. T. A. 1287; *Burkett v. Commissioner,* 31 Fed. (2d) 667, (C. C. A. 8th, 1929) *certiorari* denied 280 U. S. 565, affirming 7 B. T. A. 560; *Alexander v. King*, 46 Fed. (2d) 235 (C. C. A. 10th, 1931), reversing the District Court 38 Fed. (2d) 256.*

These cases hold indirectly that bonuses are income and not a return of capital in whole or in part.

See also *Nelson Land & Oil Co.*, 3 B. T. A. 315; *D. R. McDonald*, 7 B. T. A. 1078; *R. H. Haslett*, 10 B. T. A. 332, which hold to the same effect directly.

All these cases are agreed that bonuses are income, and not capital, in whole or in part. The only relief of the taxpayer is to set off against the income whatever depletion may be allowable to him pursuant to the deduction provisions of the act in effect. With respect to depletion there is no warrant for allowing this offset except as there is exhaustion of the property. Perhaps one of the most striking statements of how the taxpayer is required to take depletion is to be found in the opinion of the Board in *Thompson Oil & Gas Company v. Commissioner*, 15 B. T. A. 993, affirmed 283 U. S. 301. The Board in this case said (italics ours):

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*The case of Ferguson & Co. v. Commissioner, 45 Fed. (2d) 573 (C. C. A. 5th, 1930) is distinguishable on the ground that it involved a Texas lease, and the laws of Texas construe such a lease to be a transfer of oil in place.

> "That a reasonable allowance for the depletion of a wasting or exhaustible asset, such as we have here, will be obtained by considering that the recoverable value will *become exhausted in the same ratio as that which gives value to the asset disappears,* can hardly be questioned. Lynch v. Alworth-Stephens Co., 267 U. S. 364. For example, if at January 1, 1917, a taxpayer had purchased a leasehold for the recovery of oil at a cost of $100,000 with oil to be recovered of 400,000 barrels, and if, during 1918, 100,000 barrels had been *produced,* a depletion allowance of $25,000 or 25 cents per barrel would certainly be accepted as the reasonable depletion allowance for 1918."

The same idea is inherent in many cases.

See *United States v. Ludey,* 274 U. S. 295, in which depletion was described as representing "the reduction in the mineral contents of the reserves."

See *Lynch v. Alworth-Stephens Co.,* 267 U. S. 364, in which depletion is said to be related to "extraction and disposition."

See also A. R. R. 1147, C. B. 1-2, p. 138; A. R. M. 148, C. B. 1-1, p. 186, quoted on pages 19 and 20 of taxpayer's reply brief.

Furthermore, the above method of computing depletion so sanctioned by the Supreme Court in its decision in the *Thompson Oil & Gas Company* case (*supra*), is probably the only case in which the Supreme Court has definitely approved any method of computing depletion sustained. The facts in connection with the computation of depletion were that the *Thompson Oil & Gas Company* owned

an oil and gas mining lease acquired prior to March 1, 1913. On that date the recoverable oil in the reserve embraced by the lease was 278,000 barrels, and its value was $156,645.00, or $0.56347 per barrel. Between March 1, 1913, and December 31, 1915, it extracted 162,717 barrels of oil so that at the unit rate mentioned it sustained depletion amounting to $91,686.15 (162,717× $0.56347). At several places in the court's opinion this $91,686.15 is referred to as the depletion *actually sustained* in the period indicated. This clearly indicates the method to be used in computing depletion for any given period.

This court has itself apparently applied the method of depletion above outlined in its discussion on page 5, of the depletion which would be sustained, assuming there were no question of a bonus involved in this case. It is there said that the depletion should be "on each barrel of royalty oil brought to the surface," in other words, that the depletion allowance should be offset against income arising from the actual exhaustion of the oil reserves in the ground.

As above stated, the deduction for depletion does not, in essence, differ from the deduction for depreciation. (*U. S. v. Ludey, supra.*)

The concept of depreciation has been clearly stated in *Kansas City Southern Railway Co. v. Commissioner,* 52 Fed. (2d) 372 (C. C. A., 8th, 1931). It was attempted by the taxpayer in this case to secure a deduction in 1918 and 1919 for obsolescence of a building which, as the court observes, "occurred prior to 1913." The court refuses the deduction, saying:

> "The rule as to allowance for exhaustion, wear and tear of property used in the trade or business is the same as the rule concerning obsolescence. We think no case can be found holding that exhaustion, wear and tear of former years may be carried over and deducted in arriving at the income in some subsequent year. A loss attributable to a particular year is a loss occurring by reason of something happening in that year. It is not given to parties to make choice as to the years in which they will take deductions."

The opinion which has just been quoted shows a clear realization of the statutory concept which underlies not only depletion but depreciation, obsolescence, losses and all such deductions. The concept is that income must be taxed on the annual basis and that the deductions are permissible only as stated in the statute and on account of "something happening" in the year. Something apart from the receipt of income must happen. In the case of depletion there must be diminishment of the properties,—an exhaustion of that which produces the income. This is the fundamental concept which the Board had in mind.

Sections 214 and 234 contain a number of deductions of an analogous character all of which are *in pari materia*. They are all intended to compensate for the disappearance, destruction, waste or exhaustion of assets employed in the business. They all involve the same kind of statutory concept. The fact of disappearance, destruction, waste or exhaustion is what determines the allowance of the deduction. The fact that property subject to the deduction produces income does not warrant the deduction unless in producing the income the property from which the in-

come is derived is used up. Where that fact exists, the deduction is, under the statutory concept common to all these deductions, permitted. In the absence of this vital fact the entire income is taxed. There is no sanction for the theory that in each dollar of income from the property there must be some return of capital in representing an aliquot part of the property subject to exhaustion.

The analogous deduction provisions of the statute are pointed out for the reason that long established precedents and deeply imbedded practice in connection with the administration of the income tax are shaken by this court's decision in the instant case. In order to make this point clear, one of the deductions will be referred to,—that of depreciation.

Depreciation is in all respects the equivalent of depletion. It is only a name for the same process applied to properties other than those subject to depletion, such as oil reserves, mines, timber, etc. It is so equivalent to depletion that the unit-of-production method is frequently applied in determining the amount of depreciation in any particular year. But whether the unit-of-production method or the straight-line method or any other method of determining the annual depreciation allowance is used, it is well settled that the deduction is related to *exhaustion rather than the amount of income received.* It is in no way dependent upon the amount of income received. (*Hardwick Realty Co.*, 7 B. T. A. 1108, affirmed 29 Fed. (2d) 498, *certiorari dismissed* 279 U. S. 876; see also *Riech v. Heiner*, 20 Fed. (2d) 208; *Even Realty Co.,* 1 B. T. A. 355; I. T. 2369, C. B. VI-2, p. 63.)

As an instance of the radical implications of the decision of the court in the instant case the well-established doctrine may be referred to that bonuses paid to lessors in connection with *ordinary*, as distinguished from *mineral* leases, are income in the year of receipt. (*O'Day Investment Co.*, 13 B. T. A. 1230; *James M. Butler*, 19 B. T. A. 718; *Douglas Properties, Inc.*, 21 B. T. A. 347; *George W. Crile*, 18 B. T. A. 588—now on appeal in the Sixth Circuit; *Edward E. Haverstick*, 13 B. T. A. 837.) In all of these cases the Board has held that a bonus or advance payment of rent constitutes a profit to the taxpayer and is taxable for the year in which received and is not apportioned over the term of the lease.

What is the position of the taxpayer in these cases with respect to depreciation of the property leased? Is he permitted to spread his depreciation any differently because in the year when the lease was made he receives an extraordinary amount of income in the form of a bonus or advance rent? The rulings, regulations and decisions do not permit him to do so. Article 215 (a) as amended, applies only to depletion of mineral properties. It stands alone as a variation of all practice. If the article is a valid interpretation of the statute, it follows that all lessors of ordinary properties such as buildings should, under the statute, be permitted to revise all their depreciation accounts.

Regulations 45, in article 224, provide for depreciation of equipment used in connection with the production of oil. This depreciation is calculable with reference to production—exhaustion of the properties—not with reference

to the income derived from the property. Every taxpayer having such equipment should be permitted under this court's decision to revise all depreciation accounts with respect to such equipment. In other words, article 215 (a), as amended, provides for the reduction of the capital sum returnable through *depletion,* but not of the capital sum returnable through *depreciation.* Yet both deductions are made under the same paragraph of the Act. (Sec. 234 (a)(9).)

What has been said with reference to *depreciation* might be repeated with respect to losses. Losses must likewise be deducted according to the statutory concept when they are sustained and cannot be shifted to offset income from the property lost. (*Burnet v. Sanford & Brooks Co.*, 282 U. S. 359; *Kansas City Southern Ry. v. Commissioner, supra.*) Similar observations might be made regarding obsolescence.

It is respectfully submitted that this court's opinion in the respects indicated strikes at the heart of the basic concept not only of depletion and the like deductions, but at the concept of the taxable year as a unit of time,—the idea that the income tax must of necessity be administered with respect to a fixed period of time, such as the taxable year. The taxpayer respectfully urges that a decision so important, far-reaching, and so upsetting established concepts and practice, should be reconsidered so that both Government and taxpayer may for the future avoid the confusion which will follow when the real effect and implications of the opinion are generally appreciated.

POINT IV.

Article 215, as Amended, of Regulations 45. (Article 216, Regulations 69) Is Void as It Is Arbitrary and Capricious and Does Not Constitute a Reasonable Exercise of the Commissioner's Authority to Make Regulations.

Ordinarily it is not difficult to adduce proof of the fair market value of real property whether that property be a city lot, a farm or mineral lands. Scientific methods have been devised which make it relatively easy to estimate with reasonable accuracy the number of barrels of oil which a given property will produce. These two factors—value and reserves—together with the production for the taxable period, are all that are necessary for the determination of depletion in the ordinary case. To determine depletion attributable to a bonus as required by article 215 as amended of Regulations 45 it becomes necessary to introduce still another factor which the court describes in its opinion (page 16) "proof of the probable market value of the oil to be marketed under the lease in terms of dollars per barrel." This regulation is arbitrary and capricious in requiring "proof of the probable market value of the oil to be marketed under the lease in terms of dollars per barrel," in that it requires proof of that which is not susceptible of proof. Proof of the probable market value of the oil to be marketed under the lease in terms of dollars per barrel is dependent upon the production and consumption of oil throughout the term of the lease. The price of oil in terms of dollars per barrel fluctuates from time to time in accordance with the supply and demand. Such proof is so remote and speculative as not to be admissible in evidence. As illustrative of the

impossibility of proof of the last mentioned factor, suppose that today we were required to prove the amount of royalties "in terms of dollars per barrel" to be expected to be received under the remaining term of the lease. It cannot be assumed that the present price of oil will remain constant over the remaining term of the lease. It is an accepted fact that the price of oil, as the price of all other products, is always fluctuating. There is every reason to expect that in the future the price of oil will fluctuate as it has in the past. Therefore, in estimating the amount of royalty expressed in dollars per barrel to be received under the remaining term of the lease the price now prevalent cannot be used. If today's price of oil cannot be used in estimating the royalties to be expected in dollars per barrel what then can be used? The regulation which has been approved by the court specifically requires that the anticipated net market price of oil be determined. Certainly no witness can be found who would be qualified and willing to testify to the future market price of oil to supply that factor essential in the formula approved by the court.

While it is possible to estimate the number of barrels of oil which a given group of wells will ultimately produce from a given sand or zone, their monthly production may be, and in a great many cases is, restricted because of a surplus in the world's visible supply of oil. That is the condition which exists today and is a matter of common knowledge. We know what the price of oil is today and we know the daily production of our wells but we do not know when the world's visible supply of oil will be increased or decreased to such an extent that the

price of oil will be decreased or increased. From these observations, it is clear that it is impossible to prove even approximately or within a reasonable range the amount of money which will be received for each barrel of royalty oil at the time it is actually produced. Consequently it being impossible to determine this most essential factor, the formula as prescribed by the regulations and approved by this court is useless in determining the amount, if any, of depletion attributable to a bonus. That taxation is a practical matter is universally recognized by the courts. The law never requires impossibilities. Therefore, this regulation in requiring impossibilities is so arbitrary and capricious as to be invalid.

POINT V.

If Article 215 as Amended of Regulations 45 Is Valid Then the Burden of Pleading and Proving the Allocation Contended for by the Commissioner in This Case Was Not Upon the Taxpayer but Was Upon the Commissioner. Hence the Decision of the Board Should Be Sustained.

If Article 215, as amended of Regulations 45 is valid then the burden of pleading and proving that a part of the bonus payment is to be treated as a return of capital and a part as income is upon the Commissioner in this case.

The sole question presented to the court on the record was whether or not the bonus payments in their entirety constituted a return of capital or income. That was the theory upon which issue was joined and the case was tried before the Board and that was the theory upon which the

Board rendered its decision. The Commissioner's assignments of error specifically confine the case before this court to the theories advanced by the Commissioner before the lower tribunal. The Commissioner, before this Honorable Court, attempted to inject new theories into the case and it is respectfully submitted that the court departs from the assignments of error. This court was undoubtedly misled by the statement in the government's brief found on page 23 to the effect that the Commissioner at the trial had confessed error as to his original determination as disclosed in the sixty-day letter from which the appeal was taken. It is recognized, of course, that the taxpayer has the burden of showing that the determination of the Commissioner (as shown in the sixty-day letter from which the appeal is taken) is in error, but this rule does not place the burden of proof upon the taxpayer to meet new theories advanced by the Commissioner. The Commissioner is an ordinary litigant and if he desires to inject new theories into a case, he is required to do so by appropriate pleading and the burden of proof is upon him to establish the allegations made therein. The Board of Tax Appeals held that the determination of the Commissioner as shown in his sixty-day letter, which is the basis of the appeal, was erroneous. The court has also held that the Commissioner's determination as contained in his *sixty-day letter* was erroneous. It would, therefore, logically follow that the decision of this court should have been in favor of the taxpayer.

The court, in its opinion, stated that:

> "The Commissioner correctly determined that at least a part, if not all, of the bonus payment is to be

treated as return of capital. The burden is on the taxpayer to show that the computation of tax by the Commissioner is erroneous, and there is a failure of proof in this case sufficient to permit allocating a part of the bonus payment to return of capital and part to income, under the above quoted regulation."

The burden of proof does not extend beyond the scope of the theory upon which the deficiency is asserted.

The amendment of Article 215 was not made until after the Commissioner had made his determination contained in the sixty-day letter. If the Commissioner intended to rely upon Article 215 as amended, he should have amended his pleadings and pleaded the theory he now relies upon which, for the first time, was raised in his brief before the Board.

Any defense by way of a new theory to the appeal of Murphy Oil Company which the Commissioner desired to interpose should have been raised by affirmative allegations and supported by proof. The duty was upon him to do so.

Rule 14 of the rules of practice before the United States Board of Tax Appeals relative to the answer of the Commissioner provides:

> " * * * The answer shall be so drawn as fully and completely to advise the petitioner and the Board of the nature of the defense. It shall contain a specific admission or denial of each material allegation of fact contained in the petition and *a statement of any facts upon which the Commissioner relies for defense or for affirmative relief* * * *." (Italics ours.)

Rule 30 provides:

> "The burden of proof shall be upon the petitioner, except as otherwise provided by statute and except

that in respect of any new material pleaded in his answer, it shall be upon the respondent."

It is respectfully submitted that the Commissioner of Internal Revenue having failed to amend his pleadings in such a manner as to allege and prove the new issue injected into the case by his brief, the decision of the Board should be sustained.

Wherefore, upon the foregoing grounds, it is respectfully urged that this petition for a rehearing be granted and that the order of the Board of Tax Appeals be upon further consideration affirmed.

Respectfully submitted,

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Certificate of Counsel.

I, counsel for the above named petitioner do hereby certify that the foregoing petition for a rehearing is presented in good faith and in judgment of counsel for petitioner is well founded and that it is not interposed for delay.

....

Of Counsel for Petitioner.